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Regulatory Newsflash

A New European System of Financial Supervision: European Commission proposes changes to the powers, governance and funding of the ESAs

Introduction

The European Commission has proposed a legislative package that is intended to **increase substantially the powers** of the three European Supervisory Authorities (ESAs)[1] and to replace the funding currently provided by national competent authorities (NCAs) with direct funding by firms.

It is important to note that, at this stage, this is a proposal. It will now enter an approximately 18 month long legislative process during which the eventual structure and powers of the ESAs will be shaped by negotiations with the European Council and the European Parliament. The Commission, therefore,

[1] *The three ESAs consist of the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA).*

has encouraged the European institutions to treat the proposals "as a matter of priority" in order to ensure their entry into force before the end of the current legislative term of the Parliament in 2019. Despite this, in the forthcoming talks, concerns held by EU Member States and other legislators may lead to complex and potentially lengthy negotiations that could prove difficult to resolve.

This newsflash includes the analysis made by our EMEA Centre for Regulatory Strategy on the key changes proposed by the Commission and their implications for firms. More information can be found in an extended briefing note that provides a more detailed summary of the proposals.

Implications for firms

The proposals represent the Commission's early-stage vision of the ESAs' future operations. Nevertheless, the general direction of travel is clearly towards more consolidation of power at the ESA-level and away from NCAs. The key changes proposed are:

- The ESAs will become responsible for ongoing monitoring of third-country equivalence decisions.
- The ESAs will monitor and coordinate supervision of firms' use of outsourcing, delegation and material risk transfer (back-to-back business or fronting) to third countries.
- Firms will contribute directly to the funding of the ESAs.
- Restructuring of the ESAs' governance to replace each ESA's Management Board with an independent Executive Board with decision-making powers in a number of areas including dispute settlements between NCAs.
- Clarification of the ESAs' powers to "intervene decisively" on their own initiative to resolve disagreements between NCAs, and to make it easier for these powers to be applied.

Brexit considerations

As proposed, the ESAs will assume responsibility for monitoring third-country equivalence decisions. This would include any equivalence decisions that could be granted to the UK under certain provisions of financial regulation post-Brexit. In principle, any equivalence decision can be withdrawn at any time. The Commission proposed that the ESAs should have a formal role in assessing whether the criteria for equivalence continue to be fulfilled will add a further dimension to the regime governing such decisions, and so potentially increase uncertainty in this area.

In addition, firms planning on using arrangements to delegate substantial activities, or transfer material risk through back-to-back business or fronting to the UK, should take particular note that these arrangements would, under the proposals, come under enhanced scrutiny from the ESAs. The ESAs are expected to focus on activities "that may lead to a circumvention of the rules" and carried out "with the intention of benefitting from the EU passport while essentially performing substantial activities or functions outside the Union". Where the ESAs identify concerns in these areas, they may issue recommendations, including "to review a decision or to withdraw an authorisation". In this regard the Commission's proposals echo concerns already expressed by ESMA and EIOPA in their respective Opinions to support supervisory convergence in the context of Brexit.

Top-level changes to the ESAs' governance

Newly created Executive Boards will replace the Management Board within each ESA. The Executive Board will be made up of the ESAs' Chairperson and full-time members (3 for the EBA and EIOPA and 5 for ESMA). The Executive Board members will be **nominated by the Commission** based on experience, knowledge and skills, and they are **not intended to represent individual Member States**. In sum, this new arrangement appears to shift some power from national representatives to a smaller group of independent members.

Moreover, the proposed role of the Executive Board will exceed that of the current Management Board. The Executive Board will not only undertake tasks currently given to the Management Board and the duty to "examine, give an opinion and make a proposal on all matters to be decided by the Board of Supervisors", but will also have **sole decision-making powers** in the following discrete areas:

- Monitoring delegation, outsourcing and risk transfer arrangements to non-EU countries to ensure that inherent risks are addressed.
- Setting out EU-wide supervisory priorities for NCAs in a "Strategic Supervisory plan", checking the consistency of the work programmes of NCAs with EU priorities and reviewing their implementation.
- Taking decisions on stress tests and approaches to communication on the outcomes of stress tests.
- Requests for information, including the power to fine (from €50k to €200k) for failure to provide appropriate information in certain circumstances.
- Dispute settlements between NCAs, breach of Union law matters and independent reviews of NCAs.

In these areas, the Executive Board "shall be competent to act and take decisions" and "keep the Board of Supervisors informed of the decisions taken". This proposal therefore represents a significant concentration of power in the Executive Board, which in effect becomes a parallel decision-making body to the Board of Supervisors.

Greater supervisory involvement of individual ESAs

For those firms concerned, the most significant proposed impact of the proposals relating to individual ESAs' remits would see ESMA adopt direct supervisory powers for certain capital markets participants. The Commission proposes to appoint ESMA, which currently directly supervises credit rating agencies and trade repositories, as the direct supervisor of critical benchmarks and third country benchmark administrators, data reporting service providers and harmonised collective investment funds (EuVECA, EUSEF and ELTIF). This is in addition to the Commission's proposed amendments to the European Market Infrastructure Regulation, under which ESMA would directly supervise third-country central counterparties.

For insurers, the Commission proposes "to leave supervision under the recently-introduced Solvency II framework at the national level at the current stage". However, insurers seeking authorisation of internal models will see an increased role for EIOPA, which will be able, on its own initiative, to issue opinions on internal model applications. As a result, EIOPA will be able to exert greater influence on individual firms' model approval decisions.

Funding

The Commission acknowledges that the ESAs need "an appropriate funding base," and proposes a new requirement for all firms (including those not directly supervised by the ESAs) to contribute directly to the ESAs' funding. While the Commission intends to keep the current EU contribution to the ESAs' budget, it also proposes to replace the current funding from NCAs with private sector funding. Longer term, the Commission envisions that there would be "limited impact to the private sector since their contribution to privately funded national authorities would go down as the national CAs will not be any longer required to pay into the ESAs' annual budget". In practice, the net budgetary impact on firms remains to be seen, including as a result of the criteria for the calculation of the each firm's individual annual contribution to the ESAs, which would be adopted by the Commission through Delegated Acts.

Contact

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